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Leza L Olson 09/05/2006 01:06:05 PM From DB/Inbox: Leza L Olson

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C O N F I D E N T I A L SECTION 01 OF 03 TEL AVIV 003501

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NSC FOR WATERS; TREASURY FOR HIRSON

E.O. 12958: DECL: 08/31/2016
TAGS: ECON EFIN IS
SUBJECT: DANGERS LOOM AS GOI DEALS WITH ECONOMIC EFFECTS OF
WAR

Classified By: Economic Counselor William Weinstein for reasons 1.4 b a
nd d.

Summary

¶1. (C) The former Chief of Economic Research at the Ministry of Finance (MOF), Michael Sarel, says that the Lebanon War will have negative short-term consequences for the Israeli economy, but that the economy will resume its strong growth over the longer term. Despite his skepticism that the GOI will be able to reverse a "temporary expenditure shock," Sarel recognized that some additional spending is now necessary. Expenditures through 2007 will rise, but the deficit will stay close to the three percent range. Defense spending will increase significantly, but not by nearly as much as the defense establishment is requesting. Social spending will be sidetracked as will spending on education and major infrastructure projects, and "Negev development is off the map." Taxes will not be raised, but the reductions envisioned by the tax reform program which is now in progress will be delayed by a year or two. However, Sarel said that if the cease fire in the north does not hold, the resulting deterioration in the security situation will likely result in significant negative changes in the reformist policies that have helped the Israeli economy to prosper in recent years.
End Summary.

Economy Will Recover if Cease-fire Holds

¶2. (C) In an August 30 meeting, Michael Sarel, former Chief of Economic Research at the MOF and now Chief of Economic Research at Harel Investments - a top Israeli investment firm, discussed two possible scenarios for the near-term economic future with the Deputy Economic Counselor. In the optimistic scenario, the cease fire in the north would hold and the security situation would return to something approximating what it was before the outbreak of the war. In this case, Sarel said that the economy would recover very quickly. There would still be a major impact on near-term spending, and more spending on defense in the intermediate and longer terms. The tourist sector will not recover quickly, but the need to rebuild and rearm will spur growth in construction, military industries, and other areas. In such a case, 2007 would be a good year, and steady growth would resume. Growth for 2007 will likely look even more impressive when compared to 2006, with its artificially low growth rate because of the war.

Deterioration in Security Spells Trouble

¶3. (C) In the negative scenario, Sarel described a situation of continued low-level warfare in the north, with a rocket being fired in from Lebanon once or twice a week, and people unable to fully return to life as they had lived it before the war. The long-term economic implications of this type of situation are extremely negative. Tourism would not revive at all in the north, and only slowly in the rest of the country. More ominously, there may be some hesitation on the part of foreign investors to continue to invest in the many hi-tech companies that are located in that part of the country. This would seriously affect the growth rate both in the short-term and long-term.

¶4. (C) Sarel went on to say that there were two main reasons for Israel's excellent economic performance in recent years. The first was the dramatic improvement in the security situation, and the second was the government's decision to change its economic policies. Regarding security, investors used to be jittery at the news of every terrorist attack or military operation. In recent years, they have come to believe that the country is essentially stable and the economy solid. The number of terrorist attacks and civilian casualties is still very important, and Sarel stressed the need to maintaining vigilance. However, since 2002, the sharp drop in the number of attacks and the almost inconsequential impact of terrorism at the present time has dramatically improved the economic climate. A long-term deterioration in the security situation would be severely negative for the economy.

Some Reforms May Be Rolled Back

¶5. (C) The other major factor which contributed to the economy's dramatic improvement was the change in the government's policies and the implementation of the economic reform plan in 2003, which is still in progress. The "very positive policies for growth and investment," such as the reduction in expenditures as a percentage of GDP, and the reduction in the deficit and taxes have all contributed to the decrease in the risk premium for investing in Israel.

¶6. (C) Sarel noted that, in the post-Lebanon War situation, both of these factors are at risk. There will likely be economic policy changes as a result of the security situation. Most important is the push to increase the defense budget by NIS 30 billion (about USD 6.8 billion) over the next three years. Sarel said that there was no chance whatsoever that the Ministry of Defense would receive such an increase. However, even a fraction of that amount - he thought a figure in the NIS 5 billion range likely - would have a big fiscal impact. On the need for additional defense spending, Sarel noted that there is room for some savings in the defense establishment. The army has an extremely

generous pension system, which was not reformed several years ago when the GOI reformed the equally generous pension plans enjoyed by most other government employees. Regardless of the amount that defense spending is increased, this new situation represents a drastic change from pre-war plans for major defense cuts (about NIS 500 million per year for three or four years) to finance social spending.

¶7. (C) In addition, some other reformist policies will be "reversed a bit." The deficit ceiling will be raised, as will expenditures and taxes. However, on taxes, Sarel said that rates would not increase, but rather that the reform under which corporate and personal income taxes have been slowly declining would be postponed for a year or two, bringing in an additional NIS 2 billion in revenue to the government in 2007 and 3.5 billion in 2008. He also expected that the government would not change the 15.5 percent VAT rate.

Temporary Expenditure Shock Needed

¶8. (C) Sarel said that the right thing to do in the present situation was to allow for a "temporary expenditure shock," which would sharply increase expenditures and the budget deficit now on the understanding that they would be brought back into line in 2008 and 2009. However, he expressed skepticism that these increases would be reversed later. He said that the revenue side will not be much affected by the war - the reduction in tax payment will only amount to about NIS two or three billion. However, the compensation packages for businesses and individuals who suffered damage during the war and the increase in defense spending will have a big effect on the expenditure side. Sarel noted that by law, the budget deficit is set at three percent. The coalition agreement calls for it to be reduced to one percent by 2009, and the Prime Minister and Defense Ministers had agreed that it should be set at two percent for 2007. Sarel suggested that it would be prudent to allow for a reasonable three percent deficit in 2007, and to plan to go back to reducing it gradually after that.

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Only Fiscal Tricks Can Maintain the Expenditure Target
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¶9. (C) As for 2006, Sarel said that it will require some "fiscal tricks" to keep expenditures from rising by only one percent over those in 2005, as required by law. One possibility is that additional expenditures be handled "off-budget." He said that new legislation is needed to raise the expenditure ceiling, adding that since the deficit will likely stay in the three percent range, no new legislation will be needed to raise that ceiling.

Negev Development Off the Map

¶10. (C) As for the impact of the new situation on social spending, Sarel noted that much had already been done to undo the damage caused by some of the more drastic cuts in allowances over the past few years. He said that the restoration of some cuts in the child and old age allowances was done in a very modest and reasonable way that did not threaten to explode the budget. Regarding the increase in the minimum wage, he called it harmful to those it was intended to help, but economically not significant. Planned increases in education spending will likely be postponed, as will work on major infrastructure projects such as the NIS eight to ten billion allotted for road and railway projects over the next five years. He added the "Negev development is off the map," and that there will be another -- probably failing -- effort to get rid of many of the "exemptions" allowed in the tax system, such as the tax-free money in funds allotted for training courses, and the exemption on paying VAT in the southern port and resort city of Eilat.

Deficit Will Stay on Track

¶11. (C) When pressed, Sarel said he thought that while the war has caused real - but temporary - economic damage, the more optimistic scenario would ultimately play out. The increase in the deficit and fiscal targets is a negative as will be the change in the internal composition of the budget towards more defense spending. However, he expressed confidence that the deficit will remain in the three percent range, noting that the Bank of Israel, the USG, and international rating agencies will all be exerting a lot of pressure to keep the deficit under control.

JONES